

THE PRIVATE OFFERING EXEMPTION—RECENT DEVELOPMENTS

STANLEY SCHWARTZ, JR.*

The exemption provided in § 4(2) of the Securities Act of 1933,¹ has attracted the attention of an ever growing number of commentators of federal securities law.² A significant milestone in its exegesis was the adoption of rule 146 (the rule).³ The rule is entitled, "Transactions by an Issuer Deemed not to Involve any Public Offering." The title tracks the language of § 4(2), which provides an exemption from the registration provisions of § 5 of the Act for "transactions by an issuer not involving any public offering."⁴ The release accompanying the rule notes that

the Rule is designed to provide more objective standards for determining when offers or sales of securities by an issuer would be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act.⁵

The adoption of amendments to the rule in May, 1975,⁶ the issuance of numerous no-action letters and interpretive releases by the SEC, several judicial decisions,⁷ and the continued study of the subject by Federal Regulation of Securities Committee of the American Bar Association make the time propitious for a review of the present status of the private offering exemption.

* Member of the Ohio Bar; the author wishes to acknowledge the assistance of Edwin M. Walker, an associate in the firm of which the author is a member.

¹ 15 U.S.C. § 77a *et seq.* (1970) [hereinafter cited as the Act].

² Coles, *Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review*, 58 MARQ. L. REV. 395 (1975); Kinderman, *Private Offering Exemption: An Examination of its Availability Under and Outside Rule 146*, 30 BUS. LAW. 921 (1975); McDermott, *The Private Offering Exemption*, 59 I.A. L. REV. 525 (1974); Schwartz, *Rule 146: The Private Offering Exemption—Historical Perspective and Analysis*, 35 OHIO ST. L.J. 738 (1974) (hereinafter cited as Schwartz); Weinberg & McManus, *Private Placement Exemption Under the Securities and Exchange Act of 1933 Revisited*, 27 BAYLOR L. REV. 201 (1975).

³ 17 C.F.R. § 230.146 (1974).

⁴ 15 U.S.C. § 77d(2) (1970).

⁵ Securities Act Release No. 33-5487, 39 FED. REG. 15261 (June 10, 1974).

⁶ Securities Act Release No. 33-5585, 40 FED. REG. 21709 (May 7, 1975) [hereinafter cited as Amendment Release].

⁷ *Woolf v. S.D. Cohn & Co.*, 515 F.2d 591 (5th Cir. 1975); *Andrews v. Blue*, 489 F.2d 367 (10th Cir. 1973); *SEC v. Universal Major Industries Corp.*, C.C.H. FED. SEC. L. REP. ¶ 95,229 at 98, 119 (S.D.N.Y. July 14, 1975); *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104 (D. Mass. 1974).

I. AMENDMENTS TO THE RULE

A. *Communications not Deemed To Be Solicitations*

The concept of a private offering exemption by its nature excludes the possibility of general advertising or solicitation. Thus paragraph (c) of the rule as originally adopted prohibited

any form of general solicitation or general advertising, including but not limited to the following:

. . .

(3) Any letter, circular, notice or other written communication, except that if subparagraph (d)(1) is satisfied as to each person to whom the communication is directed and the communication contains an undertaking to provide the information specified by subparagraph (e)(1) on request, such communication shall be deemed not to be a form of general solicitation or advertising.

This requirement to provide extensive information relating to the issuer was applicable to each offeree whether or not such person eventually became a buyer of the securities offered,⁸ and placed a heavy burden on an offeror. The Commission's purpose in including this requirement was to discourage general solicitation. However, in the Amendment Release, the Commission recognizes that

[t]his provision created an unnecessary burden, e.g., even if an offeree decides not to purchase, the issuer would still be required to send information to him. Moreover, the Rule provides protections against general solicitation in that it requires the issuer and any persons acting on its behalf to have reasonable grounds to believe prior to making an offer that the offeree has a requisite knowledge and experience or can bear the economic risk of investment.⁹

It therefore amended subparagraph (c)(3) of the rule to delete the words "and the communication contains an undertaking to provide the information specified by subparagraph (e)(1) on request." Thus without decreasing protection for investors (since the information must be supplied whether or not the legend is set forth), the Commission has relieved the issuer of a small part of its burden.

B. *Information Requirements*

In order to meet the "furnishing of information" test, an issuer

⁸ 17 C.F.R. § 230.146 (1975). See, Schwartz, *supra*, note 2, at 759.

⁹ Amendment Release, *supra* note 6, at 21709.

that is not a reporting company under the Securities Exchange Act of 1934¹⁰ is required by subparagraph (e)(1)(ii)(b) to supply

the information that would be required to be included in a registration statement filed under the Act on the form which the issuer would be entitled to use provided that if the issuer does not have the audited financial statements required by such form and cannot obtain them without unreasonable effort or expense, such financial statements may be provided on an unaudited basis;. . . .

The application of these provisions raised certain questions; *e.g.*, (1) must an offeror furnish the financial schedules called for by Part II of Form S-1¹¹ and (2) how complete must the unaudited financial statements be? In order to provide some flexibility, the Commission amended subsection (b) to allow the issuer to omit details and employ condensations, if under the circumstances, the omitted materials are not material and their omission is not misleading. In addition, regulation A financial statements may be furnished,¹² and the financial schedules required in Part II of Form S-1 need not be provided if they have not been prepared.

C. *Business Combinations*

Paragraph (f) of the rule relating to business combinations has been among the more criticized sections. One of the problems with paragraph (f) is that it used the definition of "business combinations" found in rule 145¹³ under the Act. This definition includes reclassifications, mergers, consolidations and acquisitions of assets through a shareholder vote. Rule 145 and its definition were developed as a result of the Wheat Report,¹⁴ which led to the repeal of rule 133¹⁵ and the substitution of rule 145. In the original comments to rule 146, it was noted that: "[i]n an exchange offer [B reorganization] the issuer has a choice of offerees and, therefore, does not need the special provisions of paragraph (f)."¹⁶ The Commission modified its position in the Amendment Release, noting:

[h]owever, the Commission has reconsidered this position and now

¹⁰ 15 U.S.C. § 78a *et seq.* (1970) [hereinafter cited as 1934 Act].

¹¹ 17 C.F.R. § 239.11 (1975).

¹² 17 C.F.R. § 239.90 (1975).

¹³ 17 C.F.R. § 230.145 (1975).

¹⁴ F. WHEAT, DISCLOSURE TO INVESTORS (1968).

¹⁵ 17 C.F.R. § 230.133 (1975).

¹⁶ Release No. 33-5487, *supra* note 5, at 15,261.

believes that it is preferable not to distinguish among different types of business combinations when the result is the same, as long as there is adequate protection for investors. Therefore, the Commission is amending subparagraph (f)(1) to expand the definition of "business combination" for the purposes of the Rule to include, in addition to the transactions of the types specified in paragraph (a) of Rule 145, exchanges of stock including the type described in Section 368(a)(1)(B) of the Internal Revenue Code, commonly known as "B Reorganizations."¹⁷

D. *Number of Purchasers: Good Faith Test*

Subparagraph (g)(1) of the rule provided that, "[t]here shall be no more than thirty-five purchasers in any offering pursuant to the Rule." The amendment to subparagraph (g)(1) provides that "[t]he issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that there are no more than thirty-five purchasers. . . ." Thus the question now is one of the issuer's good faith rather than a strict numerical test. This may be the first step on the part of the Commission toward the adoption of the concept of the "I and I Defense" proposed by Carl W. Schneider and Charles C. Zall.¹⁸

It is to be hoped that the Commission will relax other aspects of the rule to permit the substitution of substantial compliance for absolute compliance. By way of illustration, consider situations where there has been omission of the legend on the certificate required by subparagraph (h)(2), or a failure to obtain a signed, written agreement from a purchaser as required by subparagraph (h)(4) of the rule, where in fact these failures did not contribute to an improper distribution. In this type of situation, the issuer's attempted good faith compliance should override any technical noncompliance with the provisions of the rule.

¹⁷ Amendment Release, *supra* note 6, at 21,710.

¹⁸ Schneider & Zall, *Sec. 12 and the Imperfect Exempt Transaction: The Proposed I and I Defense*, 28 BUS. LAW. 1011 (1973). These authors make the eminently reasonable suggestion that a plaintiff should not be able to obtain rescission based solely upon a defendant's failure to meet the requirements of a claimed exemption in its offering to another person if defendant can show that as to such other person the failure is both innocent and immaterial. However, the defense would not bar recovery by a plaintiff who could show a substantial defect in defendant's sale to him. An innocent act is the result of simple negligence as opposed to gross negligence or intentional act or omission. Immateriality is to be judged in the economic context of the transaction, in a manner to prevent a plaintiff barred from rescission by the defense from having the issuer injured by the recovery of others not barred. As to this latter point, the authors suggest, "if no more than 5% of the securities sold were done so in a defective manner, the defect should be deemed to have been immaterial." 28 BUS. LAW. at 1015.

II. INTERPRETIVE RELEASES AND NO-ACTION LETTERS

A. *Advertising*

Two interpretive releases deal with the question of advertising and its relation to the rule. In a very early release,¹⁹ a program where an oil company proposed a "blind advertisement" to appear in publications handed out on airlines and designed to identify individuals who would be potential participants in placements under rule 146, was considered to be inappropriate. It was noted that

in view of the proposed reliance of the company upon the provisions of Rule 146, there appears to be a serious question raised as to the availability of an exemption under Section 4(2) of the Act, should the proposed advertisement contribute to an effort to find proposed offerees of future privately sponsored programs.

By way of contrast, a subsequent release²⁰ advised that paragraph (c) of the rule was not intended to "preclude broker-dealers from using the media to attract issuers as customers." The release warns, however, that if individual private investors were attracted by the advertisement, the existence of a violation of rule 146(c) would be based on the special facts and circumstances of each situation. These positions are consistent with the spirit of the rule's prohibition on advertising restricting the scope of activities of issuers and broker-dealers in locating potential buyers.

B. *Condominium Sales*

Confirming the somewhat subjective impression that the rule finds more application for noncorporate issuers than for corporate issuers, a 1974 release²¹ approved without difficulty the availability of the rule to the offer and sale of condominium units that were by definition a security.

C. *Offeree Representatives as Investment Advisers*

Three recent letters dealt with the interface of the concept of offeree representative under the rule and the Investment Advisers Act

¹⁹ Damson Oil Co., CCH FED. SEC. L. REP. ¶ 79,916 [1974-75 Transfer Binder] (July 5, 1974).

²⁰ Borden & Ball, (October 23, 1974).

²¹ Russell T. Gorgone, (September 23, 1974).

of 1940.²² In one,²³ the Division of Investment Management Regulation advised that a law firm that proposed to be listed on a list of offeree representatives would be engaged in the business of rendering investment advice. Furthermore, if it received compensation for services as an offeree representative, it would fall within the definition of an investment adviser under the 1940 Act. The Division further noted that it did not appear that the exception in the 1940 Act for a lawyer whose performance of investment advisory services is solely limited to the practice of his profession²⁴ would be available to the law firm in this situation, since

performing the duties of an offeree representative would necessarily involve advising others as to the advisability of investing in or purchasing securities. At the very least, an offeree representative would be involved in the issuance of an analysis or report concerning the securities.

In this context, it might be noted that at the annual SEC Speaks, Alan B. Levenson, Director of the Division of Corporate Finance, stated that there is "an implied condition that when an offeree representative is used, he evaluates and makes the recommendation."²⁵

The facts in the Epsilon Lambda Electronics Corporation no-action letter²⁶ may be somewhat typical of what we would expect to encounter in the future. Epsilon Lambda proposed to issue shares of unregistered common stock to more than fifteen private individuals in several states. In reliance upon the rule, it engaged the Clermont Company, a registered broker-dealer to serve as offeree representative for all prospective purchasers under the proposed offer, its fee to be paid by Epsilon Lambda. The Clermont Company would not be active in soliciting purchasers and had no present intention of

²² 15 U.S.C. § 80b (1970); [hereinafter cited as the 1940 Act]. The 1940 Act provides comprehensive regulation of investment advisers, defined as

any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities, or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities;

15 U.S.C. § 80b-2(a)(ii) (1970). The 1940 Act also requires registration with the Commission, establishes record-keeping standards, provides minimum standards for advisory contracts, prohibits fraudulent transactions, and sets penalties for its violation.

²³ Winstead, McGuire, Secrest & Trimble, CCH FED. SEC. L. REP. ¶ 80,131 [1974-75 Transfer Binder]. (February 21, 1975).

²⁴ 15 U.S.C. § 80b-2(a)(11) (1970).

²⁵ 292 BNA SEC. REG. & L. REP. at A-8 (March 5, 1975).

²⁶ Epsilon Lambda Electronics Corporation, (October 11, 1974).

acting as an offeree representative under rule 146 with respect to any other transaction or as holding itself out as being interested in doing so. Under these circumstances, the Division advised that it would not recommend the Commission take any action if the Clermont Company proceeded without registration under the 1940 Act. This response makes it clear that in the case of broker-dealers, a key question under the 1940 Act appears to be the number of times one firm acts as an offeree representative.

The staff of the Commission does not appear to be fully satisfied with the various conflicts that exist between the rule and the 1940 Act. Alan S. Mostoff, Director of the Division of Investment Management Regulations, noted that, "[i]f the compensation of the offeree representative is contingent upon finding buyers, then there could be definitely a breach of the Act."²⁷ Alan B. Levenson, commenting on the same subject, said that the Commission, in deciding that the issuer could pay the offeree representative, was seeking to avoid creating a situation where another person would be involved as an intermediary and costs would be elevated. "The Advisers Act problems will have to be clarified in amendments,"²⁸ he said. Unfortunately, these amendments have not been forthcoming.

D. Offeree Representatives in Business Combinations

Another letter on offeree representatives clarified a potentially troublesome area of business combinations.²⁹ This problem involved a proposal that the chief executive officers of the acquired company serve as the offeree representatives to represent the interests of some or all of the shareholders of the acquired company. It was further noted that the officers would enter into new employment agreements, which would be guaranteed by the acquiring company. The general terms and arrangements of the employment agreements, of course, would be disclosed to the acquired company's shareholders. None of the proposed offeree representatives were affiliates of the acquiring company. In response, the Division wrote that

the chief executive officers of an acquired company are not excluded from the definition of "offeree representative" as set forth in paragraph (a)(1) of Rule 146 . . . where such persons are not officers

²⁷ 292 BNA SEC. REG. & L. REP. at A-8 (March 5, 1975).

²⁸ *Id.*

²⁹ Lancaster Colony Corp., (February 7, 1975).

of the issuer/acquiring company, notwithstanding any employment relationships between such persons and the issuer effective subsequent to a business combination.³⁰

E. *Integration of Offerings*

It is in the area of integration that the Commission has provided us with the most interesting series of no-action letters providing liberalization for the issuer and certainty for the practitioner. It will be recalled that the operative term in paragraph (b) of the rule, "Conditions To Be Met," is "offering." A determination must be made as to whether the offering in question stands by itself or whether it should be regarded as part of a "larger offering made or to be made."³¹ In securities jargon, this problem is referred to as a question of integration.

(1) Noncorporate Offerings

A problem often arises as to whether the offerings of two limited partnerships with the same corporate general partner should be considered as one offering.³² A recent no-action letter involved a Georgia corporation engaged in the breeding, training and racing of thoroughbred horses. Its principal business facility is an 1100-acre farm. From time to time the corporation purchases horses that it resells to limited partnerships. The partnerships are organized by the corporation for the purpose of raising and/or breeding the horses. Each partnership owns only one horse. Separate books and records are kept for each partnership and a separate bank account maintained for funds of each partnership. There is no interdependence among the purchasers for purposes otherwise. The corporation's president serves as the general partner of each limited partnership.

The corporation sought to offer these partnerships in reliance

³⁰ *Id.*

³¹ Securities Act Release No. 33-4552, 27 FED. REG. 11316, 11317 (November 6, 1967). A determination whether an offering is public or private would also include a consideration of the question whether it should be regarded as a part of a larger offering made or to be made. The following factors are relevant to such question of integration: whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose.

³² See Schwartz *supra* note 2, at 757 n.79

upon the registration exemption provided by §§ 4(2) and 3(a)(11)³³ under the Act and rules 146 and 147.³⁴ Based on the foregoing, the staff expressed the view that the offer of interests in separate limited partnerships as proposed would not be deemed to be part of the same larger offering solely because there is a common general partner in each of the partnerships.³⁵ It is apparent from the statement of facts that there is more in common among the partnerships than the general partner.

In the same vein, separate offerings of limited partnerships sold by the same registered broker-dealer for the same real estate developer, involving a "1975 program" of three separate apartment complexes and three shopping centers (two of which were in the same city); and a "1974 program," consisting of the first phase of an apartment complex in Tulsa, Oklahoma financed in early 1974; and a subsequent phase of the same apartment complex and a shopping center in Nebraska, were, in view of the staff "not to be integrated for the purpose of § 4(2) of the Act as parts of one or more or larger offerings of securities" even though similar projects were contemplated for 1976.³⁶

The staff responded similarly to an inquiry relating to the formation of successive limited partnerships for oil exploration and development. The request for a ruling noted that the two partnerships would not invest in any of the same or related prospects, that the profit-sharing arrangements would be different in each partnership and that the profits or losses of one partnership would in no way affect the profitability of the other partnerships. The staff's reply was, "[g]enerally speaking, it is this Division's position that each limited

³³ 15 U.S.C. § 77c(a)(11) (1971) provides in pertinent part:

Except as hereinafter expressly provided, the provisions of this subparagraph shall not apply to any of the following classes of securities:

...

(11) Any security which is part of an issue offered and sold only to persons resident within a single state or territory, where the issuer of such security is a person resident in and doing business within, or if a corporation, incorporated by and doing business within, such state or territory.

³⁴ 17 C.F.R. § 230.147 (1975).

³⁵ Dogwood Farm, Inc., (September 1, 1975).

³⁶ Dasere & Company, Inc., (June 16, 1975). This letter, together with Dogwood Farm, Inc. (September 1, 1975) may indicate a softening of the staff's position on integration. For example, one corporation was advised that twenty-six separate offerings over a period of ten years might be subject to integration. The staff subsequently refused to issue a no-action letter with respect to five proposed limited partnerships "in view of the fact that no offerings had yet been made and consequently no facts are available for interpretation." Calprop Corp. (September 28, 1971) cited in R. HAFT, *TAX SHELTERED INVESTMENTS* § 2.03[1] (2d ed. 1974).

partnership would be considered to be a separate issuer of limited partnership interests," and somewhat cryptically added, "[i]t would appear a useful inquiry as well to assume that the same issuer was involved and then consider whether that issuer was issuing the 'same class of security.'" Another interesting question contained in the same request for the no-action letter concerned the possibility of two partnerships together constituting one rule 146 offering if the aggregate number of investors in two partnerships was not over thirty-five, even though approximately half of the investors received information on one partnership and the other half on another partnership. The staff refused to rule on this question.³⁷

An earlier request involved a registered public offering of interests in an oil program together with two proposed private limited partnerships that would participate in the same oil and gas leases as the public partnership. Here the staff concluded that the two offerings, the public partnership and the private partnership, should be integrated.³⁸

One problem of integration is whether the focus should be on the independent project or on the business of the common general partner.³⁹ These letters appear to settle the question in favor of the former approach.

(2) Corporate Offerings

The concept of integration cuts across all phases of securities law. Thus an inquiry in early 1975 involved possible integration under §§ 3(a)(3)⁴⁰ and 4(2) of the Act. The § 3(a)(3) transactions involved commercial paper issued by a registered bank holding company and the § 4(2) transaction involved short-term promissory notes that did not qualify for § 3(a)(3) exemption. The short-term promissory notes would be issued by a subsidiary of the bank holding company and guaranteed by it. The staff advised that the doctrine of integration

³⁷ Guardian Oil Company, (June 19, 1975).

³⁸ May Petroleum, Inc., (August 28, 1974).

³⁹ Schwartz, *supra* note 2, at n.79; Note, *Application of the Securities Doctrine of Integration to Real Estate Syndications*, 46 S. CAL. L. REV. 428, 454 (1973).

⁴⁰ 15 U.S.C. § 77c(a)(3) (1971). This section exempts

(3) Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited; . . .

would not be applied to the two transactions.⁴¹

The staff came out on two different sides of somewhat similar inquiries relating to stock option plans. One involved the possibility of integration between an offering of shares under an unregistered restricted stock option plan and an offering under several registered stock option plans. The staff concluded that the shares were part of the same class of securities, despite varying Federal income tax treatment restrictions on transfer or pledge and resale requirements applicable to shares issued under the restricted stock option plan.⁴² The other inquiry involved a small company with a large number of stock options outstanding. The company proposed to rely on rule 146 for sales of stock under the plan to up to thirty-five participants. Thereafter, sales under the plan would be made pursuant to the registration requirements of the Act. The staff found no fault with this proposal provided six months intervened between the sales to the last of the thirty-five persons and the subsequent registered offering; under such circumstances the two groups of sales "would not be deemed to be parts of the same larger offering."⁴³

(3) Foreign Offerings

The staff has been liberal in the area of integrating foreign offerings with United States offerings. In a recent interpretation of the rule, the staff dealt with a situation in which a private offering to domestic and foreign purchasers exceeded thirty-five, although there were less than thirty-five domestic purchasers. The question was, whether for the purposes of the rule, nonresident alien purchasers of the company's common stock should be excluded in determining whether the thirty-five purchaser requirement of subparagraph (g)(1) of the rule had been complied with. The Division of Corporate Finance had no difficulty in expressing the view that nonresident aliens need not be included in the computation used to determine compliance with the thirty-five purchaser requirement of subparagraph (g)(1).⁴⁴ Several other recent letters reached similar conclusions.⁴⁵ All

⁴¹ A. S. Becker & Co., Inc., (February 18, 1975).

⁴² Rohr Industries, Inc., (February 2, 1975).

⁴³ Geosource, Inc., (June 30, 1975).

⁴⁴ Salt Cay Beaches Limited, CCH FED. SEC. L. REP. ¶ 79,985 [1974-75 Transfer Binder] (October 14, 1974).

⁴⁵ Great Southwest Corporation, (January 22, 1975); Dentsply International Inc., (October 24, 1974); Griffith Laboratories, Inc., (July 17, 1974). These letters contradict Soward's view expressed in SOWARD, 11 BUSINESS ORGANIZATIONAL FEDERAL SECURITIES ACT

these apparently implement the long standing view of the Commission that "the registration requirements of Section 5 of the Act are primarily intended to protect the American investor. . . ."⁴⁶

F. *Number of Purchasers—Bank Commingled Fund*

Note 5 to the rule states

[c]lients of an investment adviser, customers of a broker or dealer, trusts administered by a bank trust department or persons with similar relationships shall be considered to be the offerees or purchasers for purposes of the Rule regardless of the amount of discretion given to the investment adviser, broker or dealer, bank trust department or other person to act on behalf of the client, customer or trust.

This note reversed an old SEC position on discretionary accounts exemplified by a no-action letter stating that a trustee with forty-four discretionary accounts would be considered one person in counting investors under the private placement exemptions.⁴⁷

A recent interpretive release indicates a softening of the position taken in note 5. The inquiry related to a bank that established a commingled fund for the purchase of privately placed securities. Participation in the fund is limited to pension and profit sharing trusts that are exempt from federal taxation. Trusts participating in the fund will have a proportionate interest in its assets, but will not be issued any certificate or document evidencing a direct or indirect interest in the fund. Based on these facts, the staff concluded that for rule 146 purposes, purchases of the private placements would be deemed purchases by a single purchaser, namely the fund, rather than by the separate participating trusts. In reaching its conclusion, the staff noted the control that the bank would exercise over the management of the fund.⁴⁸ In view of the lack of input of the participants in

§ 4.02[1] (1973). He feels that if the

offering is made partly to persons in the United States and partly to persons in foreign countries, [then] the *total* number of offerees must be considered in determining the availability of the exemption whether the offering originates in this country or in the foreign country. For example, if ABC, Inc., a Delaware corporation, makes a million dollar stock offering, part of which is purchased for investment by a selected group of 25 or less investment purchasers in this country and the remainder to 200 in Canada, ABC, Inc. has made a public offering. [emphasis supplied].

⁴⁶ Securities Act Release No. 33-4708, 29 FED. REG. 9828 (July 9, 1964).

⁴⁷ See C. WHITMAN, PRIVATE PLACEMENTS IN RULE 146, SEC SPEAKS AGAIN (1973).

⁴⁸ First National City Bank, (October 9, 1975).

investment decisions, there does not seem to be any compelling reason to extend the protection of the rule to them; so the staff's position does not seem to violate the spirit of the rule.

III. RECENT JUDICIAL DEVELOPMENTS

A. *The Woolf Case: Rule 10b-5 In Private Offerings*

The most interesting recent judicial development is the Fifth Circuit case of *Woolf v. S.D. Cohn & Co.*⁴⁹ The *Woolf* case follows the line of that circuit's decisions on securities law issues that have provided exercise material for legal scholars to sharpen their critical faculties. After *SEC v. Continental Tobacco Co. of South Carolina, Inc.*,⁵⁰ many practitioners felt that a private placement could only be done with corporate insiders. The court in *Woolf* retreats from this extreme interpretation of *Continental*, but introduces a new note in providing a double penalty for a failure to meet the terms of the § 4(2) exemption; the court allows not only the penalties of § 12, with its short statute of limitations,⁵¹ but also an almost per se violation of § 10 of the 1934 Act and rule 10b-5 with its vague and various statutes of limitations.⁵²

Woolf involved an action under § 10(b) and rule 10b-5 for money

⁴⁹ 515 F.2d 591 (5th Cir. 1975).

⁵⁰ 463 F.2d 137 (5th Cir. 1972).

⁵¹ 15 U.S.C. § 77M (1973), which essentially provides a one year period.

⁵² 15 U.S.C. § 78j (1970):

It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:

...

- (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

17 C.F.R. § 240.10b-5 (1974):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Neither § 10 nor rule 10b-5 provide a statute of limitations, and the periods are therefore governed by state statutes. A. BROMBERG, *SECURITIES LAW: FRAUD* § 2.5(1) (1974).

damages by purchasers in a private placement. It would appear that the statute of limitations had foreclosed any action under § 12 of the Act. The trial court, sitting without a jury, characterized the plaintiffs as "sophisticated investors" and found that the defendant had not violated rule 10b-5. Plaintiffs were apparently sophisticated investors; one had actually been employed as the manager of the Miami office of the defendant's brokerage firm and had been in the brokerage business for many years. The other was an attorney of extensive experience who had made substantial investments in the stock market through the defendants. No formal offering circular was prepared or delivered to the plaintiffs. Plaintiffs did obtain written information, but it is not clear as to whether it was intended for their use.

The court characterized the question before it as

the extent to which Rule 10b-5 provides a remedy to a purchaser of securities against the issuer or others involved in the distribution when the issuer and its agents fail to conduct the distribution in such a manner that qualifies for the exemption from registration provided by Section 4(2) of the Securities Act of 1933.⁵³

It answered its question by stating, "[w]e think, however, that Rule 10b-5 is broad enough to afford a remedy for the wrongdoing that's alleged here."⁵⁴ The court concluded that

there comes a point where failure to disclose can be characterized as an "act, practice or course of business which operates or would operate as a fraud or deceit" upon the offerees in violation of the third clause of the rule [10b-5].⁵⁵

This point is reached when

the omissions or misrepresentations of information that make the § 4(2) exemption unavailable to the defendants, in their cumulative effect, were such that a reasonable investor, had the information registration would have afforded been available, might have considered them important in the making of his investment decision.⁵⁶

One wonders why, if there are such omissions or misrepresentations of information, there is not a simple violation of clause two of rule 10b-5, without going into a deep analysis of the requirements of § 4(2).

⁵³ 515 F.2d at 605.

⁵⁴ *Id.*

⁵⁵ *Id.* at 608.

⁵⁶ *Id.* at 614.

B. *The Woolf Case: The Fifth Circuit on Private Offerings*

In the course of the opinion, the court makes some interesting observations about the § 4(2) exemption and its own decisions in *Hill York Corporation v. American International Franchises, Inc.*⁵⁷ and *Continental*. Reacting to its many critics,⁵⁸ the court said

The gist of the criticism has been that *Continental* virtually requires that all offerees have "insider" status, if a transaction is to qualify as exempt under Section 4(2). We think these fears are unfounded. The quoted language must be read in conjunction with the balance of the opinion, in which we noted that, although the record reflected that there were at least 38 offerees, 35 of whom bought stock, *Continental* failed to sustain its burden of proving that there were not more than the 38 offerees revealed in the evidence adduced by the S.E.C.⁵⁹

In any event, we may be pleased there has been this explicit rejection of the inferred requirement that all the offerees have "insider" status with the issuer if registration is to be unnecessary.

Probably the part of the *Woolf* opinion that will provide the greatest food for thought in the preparation of future private placements is the emphasis on a disclosure document equal to a prospectus contained in a registration statement. As the court noted in reviewing *Hill York*, "[w]e approved the trial court's jury charge 'that every offeree had to have information equivalent to that which a registration statement would disclose,'"⁶⁰ and then again flatly "the issuer and its agents in a private placement must afford each offeree with the information registration would have afforded a prospective investor in a public offering."⁶¹ The court in applying these tests notes that the plaintiffs did not receive financial statements or other information bearing on prior performance of the predecessor corporation to the issuer, and that there was no disclosure of physical facilities and their suitability for the proposed enterprise or disclosure of capital structure, dividend rights, preemptive rights, and the like. The court added

⁵⁷ 448 F.2d 680 (5th Cir. 1971).

⁵⁸ See, e.g., Schwartz, *supra* note 2 at 746 *et seq.* The court cites S. GOLDBERG, PRIVATE PLACEMENTS & RESTRICTED SECURITIES § 2.16[a] (1971); and KRIPKE, "Wrap-Up" Revolution in Securities Regulation 29 BUS. LAW. (Special Issue) 185, 187 (1973).

⁵⁹ 515 F.2d at 610.

⁶⁰ *Id.* at 610. *Cf.* the decision in *Livens v. William D. Witter Co.*, 374 F. Supp. 1104 (D. Mass. 1974); text accompanying notes 82-88, *infra*, and the Position Paper, text accompanying notes 99-100, *infra*.

⁶¹ 515 F.2d at 613.

that the record did not show where the issuer had revealed the names and backgrounds of the directors and officers, their compensation or their options to purchase securities or any of the other requirements of Schedule A.⁶²

Two other tangential references to § 4(2) are intriguing. The first of these is the statement that "[t]he absence of any personal contact with the issuer or its agents here would tend to indicate a manner of offering more public than private, using the *Hill York* formulation."⁶³ This is somewhat reminiscent of the first draft of rule 146,⁶⁴ which required face-to-face negotiations, a proposal that was abandoned because of the many comments received noting that it was not in accord with actual securities business practice.⁶⁵

C. *The Woolf Case: Rule 146*

The *Woolf* court's comment that rule 146, although not purporting to be an exclusive definition of the circumstances under which the exemption is available, does "provide a useful frame of reference to an appellate court in assessing the validity of Section 4(2) exemptions claimed . . . ,"⁶⁶ marks the beginning of a process that practitioners have long feared.⁶⁷ It should be noted that the first preliminary note to the rule includes this statement:

[t]ransactions by an issuer which do not satisfy all the conditions of this Rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions. Issuers wanting to rely on that exemption may do so by complying with administrative and judicial interpretations in effect at the time of the transactions. Attempted compliance with this rule does not act as an election; the issuer can also claim the availability of Section 4(2) outside the rule.

⁶² 15 U.S.C. § 77aa (1970).

⁶³ 515 F.2d at 614.

⁶⁴ Securities Act Release No. 33-5336, 37 FED. REG. 26137 (November 28, 1972).

⁶⁵ Securities Act Release No. 33-5430, 38 FED. REG. 28951 (October 10, 1973).

⁶⁶ 515 F.2d at 612.

⁶⁷ See Letter from the Committee on Securities Regulation of the Association of the Bar of the City of New York to the Chief Counsel, Division of Corporate Finance, Securities and Exchange Commission, January 25, 1973: "noting the substantial conditions to the availability of the exemption set forth in the proposed Rule, the Committee believes that unless there is such an aggressive statement of non-exclusivity, it would be preferable not to adopt the proposed Rule."

However, if an appellate court, in assessing the availability of § 4(2) exemptions refers to the rule as a “useful frame of reference,” discussion becomes circular and there will be little left of the exemption outside of the rule.

Finally, concerning *Woolf*, it should be noted that a new violation of rule 10b-5 has been created—an omission of material information, although not sufficient to be actionable under clause two, may nevertheless be actionable under clause three because of the court’s requirement that each offeree be provided the information that registration would have afforded a prospective investor in a public offering.

D. *The Woolf Case: Private Offerings Outside Rule 146*

What is the present status of the § 4(2) exemption outside of the rule in the Fifth Circuit after *Woolf*? The following factors seem essential to establish such a § 4(2) exemption:

- (1) the issuer must be prepared to prove that there was a limited number of offerees;
- (2) there probably has to be personal contact between the offerees and the issuer or its agent;
- (3) the offerees probably have to be sophisticated;
- (4) the offerees must be provided with the information registration would have afforded a prospective investor in a public offering;
- (5) the private placement should stay fairly close to the guidelines provided by rule 146, except possibly, the requirement that the offeree be able to bear the economic risk of investment.⁶⁸

E. *The Universal Major Industries Case: The Second Circuit on Private Offerings*

Twenty days after *Woolf*, the United States District Court for the Southern District of New York handed down its opinion in *SEC v. Universal Major Industries Corporation*.⁶⁹ *Universal Major Industries* involved an enforcement action against an attorney accused of aiding and abetting the distribution of securities without registration. The principal issue in the case became the availability of the § 4(2) exemption. The claimed exemption involved the issuance

⁶⁸ In a footnote, the court denigrates this criteria, noting that it has not been dealt with by any of its cases, and that “[i]t is remarkable that no consideration is given to the actual risk of the investment opportunity.” 515 F.2d 612, n.14.

⁶⁹ CCH FED. SEC. L. REP. ¶ 95,229 at 98,199 (S.D.N.Y. July 14, 1975).

of common stock upon conversion of outstanding debentures that were admittedly sold in violation of the Act, due to the issuance of common stock as interest upon the debentures, the issuance of common stock in exchange for fractional interests in oil wells where the issuer or its controlling person also owned an interest in the same wells, and the issuance of common stock for cash, services or property supplied the issuer. An extract from a table contained in note 9 to the opinion⁷⁰ highlights the extent of the distribution:

	Type of Transaction	Dates	No. of Shares	No. of Transferees
(1)	Issuances upon conversion of debentures	5/68-2/71	1,117,078	262
(2)	Issuances for interest on debentures in lieu of cash payment	8/69-6/71	266,580	489
(3)	Issuances for cash, property or services	1/69-12/72	839,059	94

Universal Major Industries is somewhat reminiscent of *SEC v. Ralston Purina Co.*,⁷¹ when the large number of buyers in the alleged "private placement" are considered. Referring to *Ralston Purina*, the author has previously noted that:

[t]he Supreme Court was dealing with a situation in which there were from 400 to 1,000 purchasers of stock in a space of three years and offers to sell to 500 (sales were stopped by the litigation) in the fourth year. Of course, these 1,000 employees are members of the investing public and sales to them constitute a public offering. We can easily sympathize with the Court's decision. The Court did not have before it the question of whether sales to thirty-five artists, bake shop foremen, chow loading foremen, clerical assistants, copywriters, electricians, stock clerks, mail office clerks, order credit trainees, production trainees, stenographers and veterinarians over a space of three years would have constituted a public offering. Despite the Court's language that "an offering to those who are shown to be able to fend for themselves in a transaction not involving any public offering" and "the focus of inquiry should be on the need of the offerees for the protections afforded by registration", we suggest the Court would have reached the conclusion, under those circumstances, that "the public benefits are too remote", and

⁷⁰ *Id.* at 98,203 n.9.

⁷¹ 346 U.S. 119 (1953).

that a sale by an issuer to thirty-five of its employees was a transaction "by an issuer not involving any public offering."⁷²

The court in *Universal* continues the torturing of the decisional law applicable to the § 4(2) exemption that was commenced with *Continental*, stating

the mere *disclosure* of the same information as would be disclosed in a registration statement to all persons offered unregistered stock would not, in the absence of showing that the offerees had the requisite relationship with the issuer and the ability to fend for themselves, suffice to form the basis for an exemption under [§ 4(2)]. *SEC v. Continental Tobacco Co. of South Carolina, Inc.*, supra, 463 F.2d at 160.⁷³

As the court in *Woolf* stated, "The gist of the criticism has been that *Continental* virtually requires that all offerees have 'insider' status, if a transaction is to qualify as exempt under Section 4(2). We think these fears are unfounded."⁷⁴ *Universal Major Industries* indicates that the fears were not unfounded.

The net message of the case seems to be the sophistication-access test. Thus, "defendant failed to establish that *all* of those who purchased UMI common stock or received stock for value belonged to a class of persons who could 'fend' for themselves"⁷⁵ and "defendant failed to establish that those who received UMI common stock for value either obtained automatically, or had access to, the sort of information which UMI would have been compelled to disclose had it filed a registration statement."⁷⁶

The court finally comes to grips with the inquiry which might have formed a rational basis for disposition of the entire case by noting that,

it is conceivable that in certain circumstances, an offering to a small number of people might provide some basis for invocation of the Section 4(2) exemption. In a case such as this, however, where the transferees numbered in the hundreds, the sheer size of the distribution tends to negate the assumption that no public offering was involved.⁷⁷

⁷² Schwartz, *supra* note 2, at 776.

⁷³ CCH FED. SEC. L. REP. at 98,211.

⁷⁴ 515 F.2d at 610.

⁷⁵ CCH FED. SEC. L. REP. at 98,211.

⁷⁶ *Id.*

⁷⁷ *Id.* at 98,212.

We would suggest that this statement could have been the beginning and the end of the court's inquiry.

F. Haber and Parvin: *One-Purchaser Public Offerings*

Haber v. Bordas,⁷⁸ another recent opinion by the Southern District of New York, provides an interesting contrast with *Universal Major Industries* in terms of the number of purchasers. There was direct evidence of the offer of unregistered securities to two persons. The court observes that there was evidence of offers to others, although the extent of this evidence is obscure. No offering circular was supplied and most of the information was oral. On this kind of record, the court found that the § 4(2) exemption was not available. Relying heavily on the access formulation, the court said

the governing fact is whether persons to whom an offering was made were in such a position with respect to the issuer that they either actually had access to such information as a registration statement would disclose or had the ability to gain such access.⁷⁹

In other words, the buyer must be an insider or an institutional investor.⁸⁰ Ominously the court noted that, "Congress had required that at least 32 categories of information be included in a registration statement." In other words, not just the key facts or material information, but every single bit required by Schedule A is required under *Haber*. *Haber* is just one more example of the difficulties the courts have had in coming to grips with § 4(2). It is this sort of an opinion that makes us ask whether the case by case judge-made law can ever provide an appropriate basis for guidance of entrepreneurs in the raising of venture capital.

*Parvin v. Davis Oil Company*⁸¹ involved the sale of fractional interests in oil wells apparently only to plaintiff Parvin. The only information Parvin received was either oral or contained in the participation agreement. The court stated that while Parvin, because of

⁷⁸ CCH FED. SEC. L. REP. ¶ 95,330 at 98,656 (S.D.N.Y. October 16, 1975).

⁷⁹ *Id.* at 98,658.

⁸⁰ It is interesting to note that the plaintiff, Warren Haber, regards himself as the founder of two substantial public corporations, Campanelli Industries, Inc., formerly New America Industries, Inc., a real estate development company, and Kenai Drilling Limited, a corporation organized to own and operate oil well drilling equipment. Prospectus of Kenai Drilling Limited, February 1, 1974.

⁸¹ CCH FED. SEC. L. REP. ¶ 95,345 at 98,711 (9th Cir. October 20, 1975).

his previous experience in investing in oil properties, might be considered to be sophisticated, that alone was not sufficient without access to the requisite information—"the sort of information that would have appeared in the registration statement."⁸²

G. *Livens: A Successful Defendant*

A rare case won by the defendant is *Livens v. William D. Witter, Inc.*⁸³ The court disposed of the case easily on the basis of the one-year statute of limitations provided by § 13 of the Act.⁸⁴ But then, apparently fascinated by the facts, the opinion continued to discuss the § 4(2) issue. The placements themselves appeared to be models. The first involved twenty-three offerees and twenty investors. The second involved the same persons plus a twenty-first, and the same for the third financing. The fourth financing involved thirty purchasers including the original twenty. All of the investors were experienced businessmen and investors. Plaintiff had been employed as an investment analyst for State Street Research and Management Company, which served as investment adviser for three mutual funds with assets totalling about one-half billion dollars and included private accounts such as Harvard University Endowment Fund whose assets were over a billion dollars. Plaintiff had graduated from Harvard Business School and had an active personal portfolio. Plaintiff knew that he was buying lettered securities and understood the significance of restrictions on their transferability. Before making the first purchase, plaintiff was informed specifically that (1) the securities were highly speculative, (2) they were issued for investment by sophisticated investors, (3) existing financial records of LPC (the issuer) were incomplete and unreliable, and (4) additional financing might be required in the months ahead. Before deciding to make subsequent purchases, plaintiff received several reports, discussed its problems with individual defendants and officers of the company, visited the company's offices and attended shareholders' meetings. Plaintiff was kept well informed of operating and financial conditions. There was never any advertisement of public solicitation.

Against this near-model background, plaintiff argued the unavailability of the § 4(2) exemption for two reasons:

- (1) plaintiff did not sign an investment letter, nor did the stock

⁸² *Id.* at 98,715.

⁸³ 374 F. Supp. 1104 (D. Mass. 1974).

⁸⁴ 15 U.S.C. § 77m (1970).

certificates bear a legend to the effect that they were restricted; and

(2) neither plaintiff nor any of the other purchasers had access to the type of information that would appear in a registration statement because no such information was available. In particular, no reliable financial statements existed for the three years prior to the investment.

The court disposed of the plaintiff's first argument by noting that the investment letter "is but one of several relevant factors, and at the trial the investment intent of plaintiff and the other parties was never seriously disputed."⁸⁵

As to the second point, the court was troubled by the lack of financial statements.

Financial information covering the three years preceding the issuance of the securities, to be disclosed in items (25), (26) and (27) of Schedule A, is extremely important, generally speaking. But again, some items in the financial statements of an issuing corporation have a much greater bearing on the investment merit of its securities than others. In this case the missing information was basically the extent of accounts payable. The fact that they were not accurately recorded on LPC's books was known by all the offerees from the beginning. . . .

In the present context, the determinative question appears to be, how much reliance would the offerees probably have placed upon the particular missing information, had it been discoverable and disclosed to them, in deciding whether to invest? In this case, defendants have shown that such reliance would probably have been minimal. Thus the offerees' lack of access to the particular kind of information which registration would have disclosed in this case is not *per se* fatal to the defendants' claim of exemption but is only one of the many attendant circumstances which must be assessed in applying the *Ralston Purina* test.⁸⁶

We might contrast the foregoing somewhat relaxed view of the Massachusetts court with that of the Fifth Circuit in *Woolf* concerning the same type of omissions.

It does not appear that S.D. Cohn & Co.'s 7-½ per cent commission was disclosed until the delivery of the debenture agreement for signature, and our examination of the record does not reveal when, if ever, the additional 10% interest in the debentures was disclosed

⁸⁵ 374 F. Supp. at 1110.

⁸⁶ *Id.* at 1111-12.

. . . [i]t is reasonably clear that they did *not* receive financial statements or other information bearing on the prior performance of the predecessor corporation as they would have had the debentures been registered.⁸⁷

From this, the *Woolf* court drew the conclusion that

[i]t follows that they [plaintiff] must show that the omissions or misrepresentations of information that make the § 4(2) exemption unavailable to the defendants, in their cumulative effect, were such that a reasonable investor, had the information registration would have afforded been available, might have considered them important in the making of his investment decision. They need not show that they themselves would have relied on the information the defendants failed to disclose. *Affiliated Ute Citizens of the State of Utah v. United States*, 1972, 406 U.S. 128, 92 S.Ct. 1456, 31 L.Ed.2d 741.⁸⁸

We certainly must agree with the *Woolf* court in its application of *Affiliated Ute Citizens* though we may disagree with it on the mechanical application of the need to disclose all of the information required by Schedule A as opposed to the more flexible standards of the *Livens* court.⁸⁹

H. Andrews: Control Persons as Underwriters in Private Offerings

Probably the most unusual of the recent cases is *Andrews v. Blue*⁹⁰ decided by the United States Court of Appeals in the Tenth Circuit in November of 1973. Plaintiff owned a twenty percent beneficial interest in the outstanding shares of a real estate corporation, Cherry Creek, which were registered in the name of the defendants, who were the beneficial and registered owners of the balance of the shares. Defendants caused Cherry Creek to merge with Medic-Shield, a public corporation, and plaintiff received shares of the merged corporation in satisfaction of his twenty percent beneficial

⁸⁷ 515 F.2d at 613-14.

⁸⁸ *Id.* at 614.

⁸⁹ Although the *Livens* court concentrates on "reliance" of plaintiff (see text accompanying note 86), it appears certain that the crucial question is the materiality of the undisclosed information to the offerees. In this case, the missing information related to accounts payable; all other information appears to have been available. Even if under *Affiliated Ute Citizens*, plaintiffs need not show that they would have "relied" on the undisclosed information, surely they must show that it was material. *Affiliated Ute Citizens* blends the distinction between reliance and material into semantic stew.

⁹⁰ 489 F.2d 367 (10th Cir. 1973).

interest. Since plaintiff was not a registered owner of Cherry Creek shares, he did not receive a merger proxy or any other information concerning the transaction. The defendants, both before and after, refused to furnish him with requested information pertaining to the transaction, refused his request for registered shares, and in fact, delivered him restricted shares.

Plaintiff brought an action for damages based in part upon the contention that the issuance of the shares of the merged corporation to him was not exempt under the provisions of § 4(2). Aside from the plaintiff, only the two defendants appear to have been the recipients of the shares in this transaction. They, as the registered owners of all of the shares of Cherry Creek, had received both adequate information and were sophisticated investors. It was further conceded that the plaintiff's interest in the transaction was unknown to Medic-Shield. The trial court ruled (and the circuit court affirmed the ruling) that the plaintiff was not a knowledgeable investor and he did not have access to the available information because of the failure of the defendants to furnish him with requested information. The court also had no trouble finding that the defendants were liable as statutory underwriters under § 2(11) of the Act.

Consider the transaction from the standpoint of the issuer, Medic-Shield, who was not a party to the litigation. It was in the position of losing a private offering exemption where it had dealt with two sophisticated investors who had access to adequate information, because these investors concealed the fact that twenty percent of their interest was held beneficially for a third party to whom they had refused to furnish information.

IV. SOME THOUGHTS FROM PRACTICING ATTORNEYS

Two committees of the sections of Corporation, Banking and Business Law of the American Bar Association have issued position papers considering different aspects of the applicable criteria for the private placement exemption under § 4(2) outside of the rule. The Committee on Developments and Business Financing dealt with the § 4(2) exemption as it relates to private placements of long-term debt securities with institutions. The Committee on Federal Regulation of Securities focused on private placements of equity securities of a type typically sold to individuals and often involving a high degree of risk. The editor's note that introduces both of the papers states that while they do not represent the official views of the American Bar Associa-

tion, because of the expertise of the drafters they are entitled to "be given authoritative weight."⁹¹

A. *Private Offerings of Debt Securities*

The Position Paper of the Committee on Developments and Business Financing, Section Corporation, Banking and Business Law, which for convenience we will designate as the Debt Position Paper,⁹² emphasized that despite all the attention that has been given to the subject of private placements, the focus has been on private placement of equity, and private placement of debt has not been a problem. Thus the Debt Position Paper states:

[t]he institutional private placement of debt securities has been a major method of corporate financing for more than forty years. Since the Commission does not appear to have given public notice, by release or other action, of any case of unwarranted reliance on the section 4(2) exemption in connection with such private placements, it should be reasonably safe to assume that there have been no significant abuses in this important area of corporate financing.⁹³

After a review of the history of debt financing, the Debt Position Paper comes to the conclusion that the guides drawn from experience in cases relating to equity financing are not applicable and the Debt Position paper suggests a view of its own. Among the most important guides is that each of the offerees should be a corporation, trust, fund or other organization that qualifies as an institutional investor; that is, an investor that regularly acquires debt securities for investment. Such an institutional investor, it is concluded, is able to fend for itself within the meaning of *Ralston Purina*. Ancillary to this requirement is that there should be some limit upon the number of offerees and a record should be made of each. With regard to the manner of offering, the guides suggest that the offering should either be sold by direct negotiations between the issuer and the offeree or through an agent of the issuer, such as an investment banker.

Another guide provides that "[t]he issuer should furnish or make available to each institutional offeree sufficient information concerning the issuer and the securities being offered to enable each offeree

⁹¹ 31 BUS. LAW. 483 (1975).

⁹² *Institutional Private Placements Under the Section 4(2) Exemption of The Securities Act of 1933*, 31 BUS. LAW. 515 (1975) [hereinafter cited as *Debt Position Paper*].

⁹³ *Id.* at 541.

to make an informed decision concerning the proposed investment.”⁹⁴ The important thing to note in connection with this guide is that institutional offerees are presumed to have both the investment experience and the leverage or bargaining power to obtain the information that they require. The guides note that institutional investors ordinarily acquire securities for investment and not with the view to, or for sale in connection with, any distribution of securities. Perhaps the most substantial difference between the Debt Position Paper and general views toward equity private placements is the rejection of the concept of legends on the securities, stop transfer instructions, and nonresale agreements. Many institutional investors have substantial difficulties with the concept of legends and stop transfer instructions and will not accept securities that have them. Of course, institutional investors ordinarily do not resell, thus eliminating the need for restrictive legends when dealing with such investors. This certainly is one of the relevant differences between private placements of debt and equity securities, and in fact, representatives of institutional investors were critical of the provisions for legends in the rule.

Finally, the guides provide that the purchase and sale of the securities must be pursuant to an agreement that contains appropriate representations by the parties thereto and provisions for opinions of special counsel to the institutional investors to the effect that it is not necessary to register the securities under the Act or to qualify an indenture in respect of the securities under the Trust Indenture Act of 1939.⁹⁵

The Debt Position Paper notes the extensive volume of private placements of debt securities.

In 1973 and 1974, private placements of debt securities aggregated approximately \$7.87 billion and \$6.17 billion, respectively. This figure aggregated approximately \$39.62 billion for the period from 1956 through 1964 and approximately \$66.74 billion for the period from 1965 through 1974. Thus, private placements of debt securities for these two periods totaled approximately \$106.36 billion.⁹⁶

It expresses the belief “that it would be highly unfortunate for issuers and for the financial community in general if any developments should occur that would impair the present effective use of institutional private placements of debt securities.”⁹⁷ Obviously, this

⁹⁴ *Id.* at 538.

⁹⁵ 15 U.S.C. § 77 aaa (1970).

⁹⁶ *Debt Position Paper*, *supra* note 90, at 516.

⁹⁷ *Id.* at 542.

expression refers to the fear of the growing trend toward exclusivity of rule 146.⁹⁸

B. *Private Offerings of Equity Securities*

In the position paper of the Federal Regulation of Securities Committee (the Position Paper),⁹⁹ four principal factors in a private placement are identified:

- (1) offeree qualifications,
- (2) availability of information,
- (3) manner of offering, and
- (4) absence of redistribution.

In discussing offeree qualifications, it is noted that offerees may be qualified to understand the risk, on the basis of their ability to understand the risk—that is, sophistication; on their ability to assume the risk—*i.e.* wealth; or on their relationship with the issuer or promoter—that is, employment, family ties, friendships, or business relations. The Position Paper thus neatly ties together several varying concepts that are generally expressed by the staff of the Commission in no-action letters by the question, “Does the offeree need protection that registration affords?”

The second factor considers the availability of information. Under this heading, the Position Paper deals with the traditional concepts of access through the relationship with the issuer or economic bargaining power, in addition to the furnishing of information contemplated under the rule. In one place the Position Paper notes that it is probably adequate to give basic information concerning the issuer’s financial condition, results of operations, business, property and management, and notes that it is doubtful whether all the foregoing categories of information are required in every case.¹⁰⁰ We must contrast this position with that of the courts in the *Woolf*, *Universal Major Industries*, *Haber* and *Parvin* cases,¹⁰¹ which seem to require all of the Schedule A information.

Under manner of offering, the obvious consideration of avoiding general advertising is noted and the number of offerees is de-emphasized. The same unexceptional position is developed with re-

⁹⁸ See note 57-59 *supra* and accompanying text.

⁹⁹ Section 4(2) and Statutory Law, 31 BUS. LAW. 485 (1975).

¹⁰⁰ *Id.* at 535-36, citing *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104 (D. Mass. 1974).

¹⁰¹ See text accompanying notes 61, 77, 80 and 81.

spect to the absence of redistribution. However, the point is made that mechanical aids, such as legends, investment letters, and stop transfer orders, though useful, should not be considered as indispensable.

One of the most interesting ideas in the Position Paper is its reflections upon the question of burden of proof. Many cases involving private placements have been decided on the basis that the burden of proof is on the defendant to prove the availability of an exemption from registration requirements of § 5 of the Act and the defendant had failed to meet its burden of proof. The author previously criticized this approach.¹⁰² The Position Paper carries that analysis farther by noting that all sales of securities, regardless of the manner of offering, are subject to registration if the jurisdictional means set forth in the Act are used, including all stock traded on national stock exchanges. It notes that the exemptions are nothing but a drafting technique to separate sales requiring registration from those that do not. The position developed is that once the defendant has shown that the offering was conducted generally in the proper manner and that the plaintiff himself was a proper purchaser, the burden of going forward shifts to the plaintiff to show some defect in the transaction. The only reported case that lends support to this position is *Grenader v. Spitz*,¹⁰³ a case which involves the § 3(a)(11) exemption. The court noted that plaintiffs failed to provide evidence of sales to nonresidents of New York, and that while the burden of proof on the exemption issue is on the defendants, plaintiffs cannot rebut the defendants' *prima facie* case with mere allegations. Defendants do not appear to have offered any evidence other than affidavits of certain persons that the plaintiffs claimed were nonresidents. In these affidavits, such persons claimed to have been residents.

¹⁰² Schwartz, *supra* note 2, at 747 n.36. The essence of the criticism is the manner in which the decision on burden of proof was made, especially the apparent reliance on the case of *Schlemmer v. Buffalo, Rochester and Pittsburgh Ry.*, 205 U.S. 1 (1907). That case involved the Safety Appliance Act of 1893 that required an automatic coupling device on all railroad cars, with certain exceptions. Plaintiff's decedent was killed while trying to couple a steam shovel to a train which did not have the device. On appeal, defendant railroad argued that plaintiff had not proved that the steam shovel was not the kind of car exempted from the statute. Justice Holmes ruled that the burden was on the defendant to show that the cars were exempt from the statute. Plaintiff's decedent was clearly among one of the classes of persons whom the statute was designed to protect. It is less clear that this is true of the plaintiffs in several of the cases noted herein, such as *Haber*, *supra* note 78. Nor is the Act as straightforward as the Safety Appliance Act of 1893 either in content or drafting technique.

¹⁰³ 390 F. Supp. 1112 (S.D.N.Y. 1975).

V. CONCLUSION

Roderick M. Hills, Chairman of the Securities and Exchange Commission, in a recent speech stated "[i]f we can make it cheaper, particularly for small businesses and developing companies, to raise capital, those companies may not have the same tendency to be squeezed out of the capital market in the months and years ahead."¹⁰⁴ From our prior examination of rule 146 and the review of recent litigation, it is evident that neither the Commission nor the courts have come to grip with this problem of venture capital formation.

One avenue of hope is presented by the proposed Federal Securities Code being drafted under the guidance of Louis Loss as the reporter. Section 227 provides a simpler scheme for what is defined as a limited offering.¹⁰⁵ Another possibility may be found in the exemptive powers of the Commission under § 3 (b) of the Act.¹⁰⁶ We have previously outlined a plan for the full use of the Commission's exemptive powers for a limited offering.¹⁰⁷ Some discussion is heard

¹⁰⁴ N.Y. Law Journal, December 15, 1975.

¹⁰⁵ (1) A "limited offering" is one in which the following conditions are satisfied: (A) the initial buyers of the securities are institutional investors or not more than thirty-five other persons or both; (B) resales of any of the securities to persons other than institutional investors within three years after the last sale to any of the initial buyers other than institutional investors do not result in more than thirty-five owners of those securities (apart from any institutional investors and persons who become owners otherwise than by purchase) at any one time, unless the resales are pursuant to an offering statement, a distribution statement, or an exemption; and (C) the original offeror and all sellers in such resales comply with any rules adopted under paragraph (4).

(4) The Commission may require by rule (A) that the seller, as well as any reseller within the one-year or three-year period (as the case may be) specified in paragraph (1) and (2), obtain an appropriate written undertaking from his buyer in an offering that purports to be a limited offering, (B) that a security that is the subject of a limited offering contain an appropriate restriction on transferability, and (C) that any transfer agent be given an appropriate stop-transfer notice, in each case designed to avoid a distribution that would violate section 501(a) or 509(b).

Federal Securities Code, § 227(b); Reports Revision of Text of Tentative Drafts Nos. 1-3, October 1, 1974, The American Law Institute.

¹⁰⁶ The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$500,000

¹⁰⁷ 15 U.S.C. § 77(c) (1970).

about increasing the amount of the exemption under § 3(b) from \$500,000 to \$1,000,000.¹⁰⁸ This is entirely appropriate in light of today's inflationary economy. With the attention of the Chairman of the Commission focused upon these problems, there may be hope that changes will come.

¹⁰⁸ Schwartz, *supra* note 2, at 777, 779.